Buffalo City Metropolitan Municipality

South Africa Local Authority Analysis | **February 2018**

Rating class	Rating scale	Rating	Rating outlook	Review date
Long term	National	A(ZA)	Stable	January 2019
Short term	National	A1(ZA)		

Financial data:

(USD'm comparative)

	30/06/16	30/06/17
R/USD (avg)	14.51	13.61
R/USD (close)	14.78	13.05
Total assets	1,170.2	1,506.5
Total debt	33.6	34.1
Total capital	1,011.4	1,344.9
Net debtors	76.5	100.3
Cash & equiv.	160.6	129.5
Total income	414.2	451.7
Net result	44.5	18.6
Op. cash flow	96.1	47.4
Net capex	(80.6)	(93.8)
Market cap.	n.a	
Market share *	3.2%	

* Share of category A municipal income in FY17.

Rating history:

Initial rating (August 2003)
Long term: BBB(ZA)
Short term: A3(ZA)
Rating outlook: Stable

Last rating (November 2016)
Long term: A(ZA)
Short term: A1(ZA)
Rating outlook: Stable

Related methodologies/research:

Global Criteria for Rating Public Entities, Updated February 2017

Buffalo City Metropolitan Municipality ("BCMM") rating reports (2003 – 2016)

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Summary rating rationale

- BCMM's status as a metropolitan municipality is positively considered given the greater operational freedom it offers, as well as the additional government support received. The latter is demonstrated through uptick in grant income from R902m in FY12 to around R1.6bn in FY16 and FY17.
- BCMM's operating performance has been constrained by the weak economic environment in the region. In particular, weakness in the core industrial sector has resulted in an increase in the regional unemployment rate and growing indigent population. As 69% of rates derive from the residential sector, this has negatively impacted income and liquidity.
- BCMM evidenced 2% income growth in FY17, constrained by subdued electricity receipts and a decline in grants, despite the strong growth in assessment rates and water services. Moreover, growth in expenditure exceeded income, resulting in a 61% drop in the surplus to R253m in FY17 (FY16: R645m).
- The key operating challenge for BCMM remains the deterioration in the debtors book profile. Thus gross consumer debtors climbed to over R2bn (FY16: R1.87bn), total net debtors increased 17% to R1.3bn at FY17. This was despite 48% growth in impairments. To improve collections, BCMM is implementing prepaid and smart electricity metering, while a debt collections contract is being considered.
- The metro reported a working capital absorption of R855m in FY17 (FY16: R182m) which saw the cash balance ease to R1.7bn (FY16: R2.4bn). However, BCMM has maintained a strong liquidity profile with cash on hand reported at 92 days (FY16: 149 days) and the current ratio at 1.9x in FY17 (FY16: 2.0x).
- Gross debt amortised to a low R446m at FY17 (FY16: R497m), while the gross debt to income ratio showed a downward trend over the review period from 14.9% in FY13 to 7.2% in FY17 (FY16: 8.3%). While BCMM has indicated its intention to raise borrowings to fund capex going forward, based on projections, the gearing ratio is likely to remain low at between 10-20%.
- BCMM attained an unqualified report from the Auditor General for FY17. Where emphasis of matters were drawn, these related the slow recovery of overdue accounts and irregular expenditure, with the quantum of such matters decreasing.

Factors that could trigger rating action include:

Positive change: The successful implementation of ongoing operational projects that improve efficiencies and aid debtors collection would be positively considered. In the medium term, an upgrade is dependent on capex projects that stimulate economic activity and employment growth, enhancing sources of income.

Negative change: The sustained weakness in the local economy, particularly the industrial sector, could further impair the debtors book performance, constraining cash flows.

Fundamentals

BCMM is located in the Eastern Cape Province and includes East London, Bhisho and King Williams Town, as well as the townships of Mdantsane and Zwelitsha within the corridor of rural areas. Following the local government elections held in August 2016 certain areas of the GreitKei, Amahlati and Ngqushwa municipalities were incorporated into BCMM. This covers approximately 2,515km^2 with 68km of coastline. Economically, the motor industry plays an integral role with East London well positioned for the exporting of vehicles. BCMM became a metropolitan municipality in May 2011, giving it exclusive powers pertaining to building regulation, local tourism, parks and recreation, health services, public transport, cemeteries, beaches, water and sanitation, and general municipal planning.

Table 1: Select Census Statistics		**2001**	**2011**	**2016**
Population (thousands)	BCMM	704.9	755.2	810.5
	EC	6,278.7	6,562.1	6,996. 9
	RSA	44,819.8	51,770.6	55,653.6
Employment - official unemployment rate (%)	BCMM	53.1	35.1	n.a
	EC	41.6	29.8	n.a
	RSA	54.3	37.4	26.6[+]
Housing - formal housing (%)	BCMM	62.9	72.5	70.6
	EC	51.5	63.2	65.1
	RSA	68.5	77.6	79.2
Housing - average household size (#)	BCMM	3.6	3.2	3.3
	EC	4.1	3.7	3.9
	RSA	3.8	3.4	3.3
Households with direct access to piped water (%)	BCMM	31.8	52.6	97.7
	EC	18.6	32.8	75.1
	RSA	32.5	46.3	83.5
Households with flush toilets (%)	BCMM	63.9	68.8	73.1
	EC	31.8	40.4	52.3
	RSA	50.0	57.0	60.6
Households with electricity for lighting (%)	BCMM	63.3	80.9	86.8
	EC	50.2	75.0	86.6
	RSA	70.2	84.7	90.3

* As per 2016 STATS SA reemployment report, relating to year-end 2015.
+ Based on the 2016 Community survey and is not comparable to census results as it includes access to water through communal taps, in addition to water in yard

Reflected in table 1 are selected socio-economic indicators from the 2001 and 2011 censuses as well as the 2016 community survey. The Eastern Cape tends to lag South Africa in relation to the delivery of basic services such as pipped water and electricity. In contrast, BCMM displays measures that are better than the Eastern Cape and, in some cases, the country as a whole. This largely reflects its position as the economic hub of the region, where infrastructure is of a higher standard, and access to service is better. Nonetheless, BCMM has been affected by the weak automotive industry while the non-automotive sector has been impacted by general economic challenges. This has led to some factories closing down and material job losses.

The East London Industrial Development Zone ("IDZ"), in which BCMM has a 27% stake, was established as a solution for the much needed economic development. The IDZ's mandate is to ensure the creation of new jobs by attracting investments into the region, albeit uptake has been slow. This has partly been the result of the relatively small size of the port compared to Port Elizabeth or Coega, which has resulted in it trailing in terms of industrial investment. In partnership with Transnet, BCMM plans to upgrade and extend the East London port, but this will only happen over the long term as there are no plans in place.

The Buffalo City Metropolitan Development Agency ("BCMDA") was established 2016 with the mandate to attract investors to the region. This includes assessing the strengths and weaknesses of the metro and designing initiatives to help attract economic activity. While much of the work has focused on the industrial sector, tourism has also been identified as a potential growth area. BCMDA aims to implement programmes to enhance the region's tourism offerings and enhance the visitor experience. One such initiative is the upgrading of the water park in Esplanade, East London. The project is currently in the conceptual stages with the proposal awaiting council approval.

BCMM currently has major developments under consideration in three areas of strategic priority, identified because they address infrastructure and service backlogs, which have hindered development. The priority areas and respective projects are as follows:

- The central urban core (East London and Mdantsane): Projects in this sector focus on the redevelopment of the inner-city and the Amalinda Junction Precinct. The municipality will implement a sewer tunnel project which will allow for the development of residential units. This will aid in the densification in the city over time.
- West Bank area: These projects entail augmenting bulk water and wastewater treatment infrastructure to ensure sufficient capacity to accommodate forecasted industrial and commercial investments. The successful completion of the projects will also provide the infrastructure required for IDZ to function optimally.
- King William's Town ("KWT") and Bhisho: The construction of a corridor between Bhisho and KWT will support the initiatives to consolidate Bhisho as the provincial administrative capital.

While above projects will only contribute to income over the medium to long term, the expenditure required to address BCMM's current challenges continues to exceed available funding. Thus, revenue management is a key focus area for the municipality, with the focus on more accurate and timely monitoring, billing and collections. To this end, BCMM is implementing a smart billing system aimed at switching businesses to an automated meter reading ("AMR"). This smart billing system allows for real time measurement of usage and tariffs. The pilot phase is being undertaken and once complete the electricity meters will be rolled out to businesses over the next few years. The majority of BCMM's residential customers now receive pre-paid electricity, with only 5,795 residents (generally from more affluent areas) on conventional metres. BCMM has also focused on strengthening management practices to facilitate the execution of the initiatives mentioned above. Critical to the efficient functioning of the metro and long term planning has been the appointment of several new staff to fill vacant management roles, most importantly that of the city manager.

Administration

The Auditor General of South Africa ("AG") issued an unqualified audit report on BCMM financial statements for 2016/2017 ("FY17"). This was the first year an unqualified audit was achieved, with the AG of the opinion that the financial statements present the financial position of BCMM fairly. Nevertheless, there were four items to which emphasis was drawn, relating to regular operating issues affecting all municipalities.

- The AG noted irregular expenditure of R287.3m in FY17 (FY16: R531.6m), incurred mainly due to a failure to follow correct supply chain management processes.
- Cumulative debt impairment provisions amounted to R1.2bn at FY17 due to the slow recovery of overdue accounts (FY16: R1.1bn).
- Material losses relating to electricity totalled R218.8m, (of which 60% is non-technical) while a water loss of R100.8m was incurred. However, the metro has initiated steps to improve performance.
- Figures in the FY16 financial statements have been restated as a result of errors discovered in FY17.

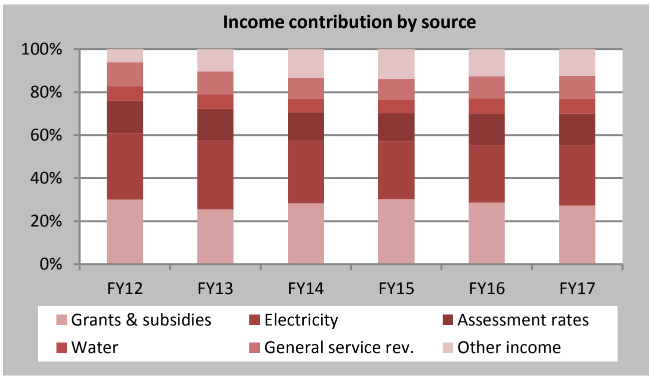
Much of BCMM's R2.4bn irregular expenditure balance relates to historic issues which cannot be resolved in the short term. Annual increases in the metric do indicate on going deficiencies in financial management. Nevertheless, GCR does note that the quantum of annual irregular expenditure continues to decrease.

Sources of income

Table 2: Sources of income (FY17)	Industry*	BCMM		
	%	%	R'm	% Δ
Assessment rates	19.7	15.9	978.2	12.1
Electricity	37.7	27.2	1,670.6	2.0
Water	10.5	9.0	551.6	11.5
General service rev.	8.8	10.5	645.7	3.2
Grants & subsidies	14.5	25.4	1,564.6	(4.3)
Other income	10.9	12.0	739.1	(0.5)
Total	**100.0**	**100.0**	**6,149.8**	**2.4**

* Average of all metropolitan municipalities.

FY17 saw income grow by a marginal 2% to a review period high of R6bn. Income growth was aided by the strong assessment rates and water service receipts, and to a lesser extent general services, which offset lower grant receipts.



- **Grants and subsidies**

BCMM remains highly dependent on the national government as grants consist 25% of total income in contrast to the industry average of 14.5%. This is to be expected given BCMM's smaller size relative to other metros. In addition, its positioning in the relatively underdeveloped province of the Eastern Cape limits opportunities for revenue diversification. In light of this the R69m (4%) decrease in grants and subsidies received to R1.56bn in FY17 is negatively considered.

Table 3: Grants and subsidies	FY16		FY17	
	R'm	%	R'm	%
Operating projects	112.4	6.9	90.8	5.8
Housing projects	183.8	11.2	105.9	6.8
BCMDA	-	0.0	1.0	0.1
Property, plant and equipment	670.4	41.0	669.8	42.8
Unconditional[1]	667.5	40.8	697.1	44.5
Total	**1,634.1**	**100.0**	**1,564.6**	**100.0**

This notwithstanding, a further breakdown of the grant receipts reveals continued strong support from the national government. In this regard, unconditional grants, which are primarily utilised to meet the cost of service provision to indigent residents, advanced by 4%. The increase would have been even higher, but a portion of grant income was classified as income from water services (explained further in the water section).

Conditional grants declined, as funds allocated for operating and housing project were lower. This was largely due to a curtailment of projects at the provincial level, where many projects are determined. Nonetheless, BCMM utilised a high 93% of conditional grants and 100% of the Urban Settlement Development Grant (USDG). Expenditure on the maintenance and extension of PPE remained flat in FY17 and largely in line with budget.

Although unspent conditional grants increased slightly, projects for which they were intended did advance. Outlays undertaken by municipalities are executed over a number of years thus, having a portion of grants unspent at year end is normal.

[1] Unconditional grants mainly comprise of the equitable share grant, which is determined by formulas that take into account demographic and developmental factors and is therefore mainly used for indigents. BCMM provides services to around 83,000 indigents. These customers get a R486 rebate per month for rates and services. The second major grant item derives from the urban settlement development grant, and is designed for the provision of infrastructure in poorer areas.

- **Assessment rates**

Assessment rates have consistently been the third highest contributor to revenue for the council. Rates income advanced by 12% to R978m in FY17. With only a marginal hike in property valuation (due to residential and commercial properties), growth in assessment rates was mainly due to tariff increases.

Table 4: Property valuations (R'm)	FY16	FY17
Residential	47,221.5	47, 677.4
Commercial	17,292.3	17,750.9
Public benefit organisation	55.7	75.6
Municipal	9.4	9.4
Rural communal land	2,985.0	2,870.5
Educational	1,644.1	1,662.1
Agricultural	2,932.3	2,911.5
Public service infrastructure	665.2	598.6
Vacant land	3,359.6	3,312.2
Total	**76,165.1**	**76,868.2**

Given the increasing strain felt by the general population, such high tariff increase may not be sustainable going forward. Nevertheless, tariff increases are expected to exceed inflation and range between 7%-8% over the next three years. Revaluations were conducted between July and December 2017 and are now open for public comment. These valuations will be implemented from 1 July 2018, being the start of FY19.

- **Electricity**

BCMM is an implementation agent for the Department of Energy's Integrated National Electrification Program, which seeks to provide access to electricity to all. As part of the programme, BCMM supplies a minimum of 40 AMPS to formal (RDP) and informal houses. Given that the project is aimed at improving service delivery for low income consumers, much of the funding stems from grants and once-off connection fees (this is waivered for indigent consumers).

Electricity is the largest source of income, constituting 27% of total income at R1.7bn in FY17 (FY16: R1.6bn). Although the income derived from the service only rose marginally, due to the low 1.8% tariff increase granted by the regulator, the cost of bulk electricity in FY17 increased 8%. This resulted in downward pressure on the electricity profit margin, from 26.1% in FY16 to 18.6% in FY17. The reduced profitability was also due to a high electricity distribution loss of 16% in FY17 equating to R219m in lost income. This compares with losses of 14.5% (R180m) in FY16. Of this, technical losses were unchanged at 6.5%, but non-technical losses (arising from theft and faults) rose slightly at 9.6% from 8% in the previous year. Electricity theft has been a major contributing factor to the losses and a case was registered with the NPA for the prosecution of a known organised crime syndicate that has been linked to illegal connections. The implementation of the smart system should further assist in this regard and provide early identification of irregularities.

- **Water**

BCMM is the Water Services Authority for its area of jurisdiction, as well as the bulk Water Service Provider for around 80% of the municipal area. In contrast to electricity, BCMM was able to increase water revenue by 12% (R551m), while the bulk water cost augmented by 7%. Consequently, the profit margin showed an uptick from 62% in FY16 to 64% in FY17. The higher income was largely attributed to the roll out of meters in the rural and semi- rural areas. The ability to more accurately measure water usage allowed BCMM to account for a larger portion of general transfers as water income. Further evidence of improvement is the reduction in technical losses from 30% to 21.6% albeit non-technical losses deteriorated to 12.5% (FY16:10.9%).

Expenditure

Table 5: Expenditure (FY17)	Industry* %	%	Actual R'm	% Δ	Budget R'm
Salaries and wages	25.9	27.4	1,616.5	10.3	1,809.7
Electricity	32.2	23.1	1,360.8	9.6	1,526.6
Water		3.4	197.7	7.0	
Grants & donations	1.7	6.7	394.8	63.9	288.0
Depreciation**	7.4	13.7	807.1	(9.0)	748.7
Other expenses	23.8	15.7	924.4	(15.4)	1,409.6
Repairs & maint.		6.5	383.0	11.2	
Bad debts	7.2	5.3	310.9	48.0	303.9
Net interest	1.8	(1.7)	(98.7)	n.a	52.1
Total	**100.0**	**100.0**	**5,896.5**	**10.5**	**6,138.6**

* GCR estimate based on metro results.
** Including asset impairments.

Total expenditure increased 11% to a review period high of R5.9bn in FY17. The main cost drivers remain salary costs and bulk electricity, both increasing by around 10% from the previous year. The bulk of staff cost arise from basic salaries, which are determined through sectoral bargaining agreements. This limits the ability of the metro to contain these costs. Nevertheless, high levels of overtime (R125m in FY17) have contributed to staff cost inflation over recent years. In efforts to curb this expenditure, overtime work now has to be approved by supervisors beforehand. The stricter approval processes also apply to travel and entertainment claims. Overall, staff expenses accounted for 27% of total costs, remaining below the GCR 35% benchmark.

Repairs and maintenance rose by over 10%, exceeding the 9% increase in the depreciation charge, indicating greater efforts to maintain existing infrastructure. GCR notes that the quantum spent on repairs continues to lag depreciation, but BCMM has indicated that much of the replacement and refurbishing activities form part of capex. In this regard, BCMM reserves cash against its depreciation charge, which is often used to refurbish and renew infrastructure.

The impact of the weaker economic environment was evidenced in the 48% rise in bad debt charges, signalling the reduced ability of residents to meet their obligations. Consumer weakness was further highlighted by the rise in grants and subsidies, 65% of which is allocated to social welfare.

Financial performance

A five-year financial synopsis for BCMM is reflected at the back of this report with brief comments provided hereafter.

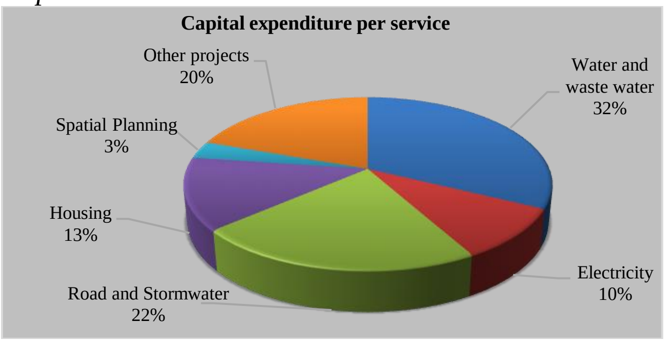
BCMM has reported surpluses over the five-year review period, albeit the surplus margin has steadily reduced since FY14, from 12.8% to 4.1% in FY17. Following a 10% rise in expenses, measured against 2% growth in income, the surplus declined by 61% to R253m in FY17. Interest income dropped slightly to R148m (FR16: R155m) on the back of the lower cash balance, but this was countered by the decrease in interest expense, resulting in net interest of R99m (FY16: R91m), a review period high.

Cash flow analysis

Cash generated by operations reduced to R1.5bn in FY17 from a review period high of R1.6bn at FY16. More significantly, BCMM reported a large working capital absorption of R855m (FY16: R182m), well above historical levels. On the one hand, this was attributed to a R496m growth of the debtors book, reflecting the more difficult operating environment. Conversely, the large outflow of R316m for payments to creditors provides some evidence of improved operating performance, and the metro's successes in implementing its policies to settle outstanding creditors within 30 days (and even faster for small businesses). Accordingly, cash generated from operations decreased to R646m from a review period high of R1.4bn at FY16. Operating cash flow coverage of gross interest thus halved to 10.1x from 23.8x in FY16, but remains strong.

Capital investment advanced 9% to R1.3bn (FY16: R1.2bn), raising the cumulative spend to R4.5bn over the five-year review period. Whilst cash generated by operations has generally been sufficient to cover the necessary capex, a considerable portion of internal cash resources were utilised to fund working capital.

Capex



There has been a strong increase in annual capex over the review period, from R590m in FY13 to R1.3bn at FY17. In addition to the quantum of expenditure, BCMM attained c.85% (FY16: c.78%) of its adjusted capital budget signifying improved implementation. The most substantial expenditure was on water and waste water as well as roads and storm water projects. The construction of a pedestrian bridge in KwaTshathsu was 90% complete at the end of FY17.

Table 6: Capex & funding budget (R'm)	Budget			
	FY17*	FY18	FY19	FY20
Infrastructure capex	**1,494.2**	**1,639.3**	**2,167.0**	**2,282.3**
Governance	111.5	63.9	115.6	136.6
Community	222.4	316.1	228.5	203.6
Economic	524.8	551.2	781.4	785.1
Trading services & other	635.5	708.0	1,041.5	1,157.0
Capex funding	**1,494.2**	**1,639.3**	**2,167.0**	**2,282.3**
Internal funding	764.0	685.0	906.6	856.8
Grants funding	730.2	795.3	931.4	999.5
External funds	-	159.0	329.0	426.0

* Based on initial unaudited figures in the C4 schedule.

Looking forward, capex is projected to rise to R1.6bn in FY18 and increase further to R2.2bn and R2.3bn in FY19 and FY20 respectively. As in previous years, expenditure will be relatively evenly split between grant and internal sources, with the weighting towards grant funding due to projects driven by national/provincial government. Nevertheless, GCR notes BCMM is planning to start funding a portion of capex through borrowings.

Funding profile

BCMM's investment in infrastructure is reflected in the fixed assets growth over the review period, from R10.2bn in FY13 to R15.8bn in FY17. This constitutes 80% of the metro's balance sheet in FY17 (FY16: R75%). Generally, infrastructure investments are funded through grants and internally generated funds which has led to the rise in accumulated surplus from R10.5bn to R17.6bn.

FY17 saw the first draw down of cash reserves in five years, reducing cash holdings to R1.6bn. BCMM reported a strong net cash position over the review period supported by low levels of debt. Cash reserves are held with five major financial institutions as short term deposits. Unspent conditional grants increased to R250m (FY16: R211m). Excluding unspent grants, days cash on hand was reported at 92 days (FY16: 149 days), remaining above GCR's 90 days benchmark. Similarly, free cash coverage of debt remained strong, at 3.2x (FY16: 4.4x) while the current ratio of 1.8x reflected adequate levels of liquidity.

Table 7: Liquidity position (R'm)	FY13	FY14	FY15	FY16	FY17
Total cash	1,841.7	2,162.7	2,198.8	2,373.9	1,690.1
Unspent conditional grants	(450.1)	(213.7)	(191.5)	(211.3)	(250.8)
Free cash	**1,391.6**	**1,949.0**	**2,007.3**	**2,162.6**	**1,439.3**
Gross debt	652.5	603.4	546.1	496.5	445.8
Days cash on hand (total)	174.3	182.7	169.2	163.2	107.6
Days cash on hand (ex cond. grants)	131.7	164.6	154.4	148.7	91.6
Free cash coverage of debt (x)	2.1	3.2	3.7	4.4	3.2

Gross debt fell to R446m in FY17 (FY16: R497m), decreasing in line with scheduled amortisation payments. The gross debt to income ratio shows a downward trend over the review period from 14.9% in FY13 to 7.2% in FY17 (FY16: 8.3%). Existing debt facilities are provided by RMB and DBSA. BCMM has secured a loan facility of R435m for the Tunnel project, which would likely see gearing rise to between 10-20% (based on FY19 projected income). However, the council is assessing the viability of activating this facility largely due to the current difficult economic environment and the impact of repayments on local residents.

Debtors book

Although the debtors book constitutes only 7% of BCMM's balance sheet, movements therein have a significant impact on liquidity. This was evidence in the working capital absorption, as the debtors balance rose by 17% to R1.3bn at FY17. As debtors are heavily weighted towards the consumer sector (69%), the debtors book has been significantly impacted by the challenges in the local economy.

The metro has historically issued consolidated bills on a basis where payments are allocated first to rates then other services, and lastly to electricity. This has helped BCMM maintain low levels of electricity debtors as they are able to cut off the supply when there are amounts outstanding. However, the disconnections could not be implemented in the Inland region at 3Q FY17 due to unstable ICT networks. This limited BCMM's ability to enforce full payment and placed additional pressure on outstanding debtors.

Table 8: Debtors	FY16		FY17	
	R'm	%	R'm	%
Rates	435.7	23.1	577.3	28.0
Electricity	228.9	12.1	266.2	12.9
Water	560.7	29.7	575.3	27.9
Sewerage	181.1	9.6	183.7	8.9
Refuse	240.6	12.8	248.3	12.0
Other	237.6	12.6	213.9	10.4
Gross cons. debtors	**1,884.6**	**100.0**	**2,064.7**	100.0
Less provisions	(1,097.3)		(1,189.2)	
Net cons. debtors	**787.3**	**69.6**	**875.4**	66.9
Other debtors	343.8	30.4	433.6	33.1
Total net debtors	**1,131.1**	**100.0**	**1,309.0**	100.0

* Unaudited.

An analysis of aging buckets further emphasises the increased stress on the debtors book. While debtors outstanding for 30 days has decreased, the other buckets have continued to expand. The deteriorating age analysis indicates continued underperformance in debt collection and a greater amount of cash flow tied up in debtors.

Table 9: Debtors age analysis	FY16		FY17	
	R'm	%	R'm	%
Current (0-30 days)	382.6	21.4	374.4	19.0
31-60 days	76.4	4.3	102.7	5.2
61-90 days	47.4	2.6	58.1	3.0
91-120 days	48.1	2.7	61.8	3.1
121-365 days	326.1	18.2	394.0	20.0
365+ days	907.8	50.8	976.8	49.6
Total	**1,788.4**	**100.0**	**1,967.8**	**100.0**

GCR does, however, note the metro's initiatives to improve collections. These include the aforementioned consolidation of bills to ensure consumers receive one account. BCMM has also begun a tender process to appoint and external collection agency to help with debtors collections.

Operating estimates and capital expenditure

Table 10: Tariff increases (%)		Budget		
	FY17	FY18	FY19	FY20
Assessment rates	7.6	9.6	8.5	8.0
Refuse	7.8	9.8	8.7	8.6
Sewerage	7.8	9.8	8.7	8.6
Water	8.0	1.9	1.76	1.73
Electricity	7.6	9.5	8.1	8.0
Fire Levy	7.6	9.2	8.0	7.9
Sundry Income	7.6	9.2	8.0	7.9

Total income is anticipated to rise 12% to R6.4bn in FY18 and a further 8% to R7.4bn in FY19. In both years, rising income will be underpinned by higher tariffs for services rendered, as well as higher external receipts in the form of operational and capital grants. In this regard, medium term tariff increases have been set marginally above CPI, to ensure services produce revenue sufficient to cover the rising associated costs.

Table 11: Operating performance (R'm)		Budget	
	FY17	FY18	FY19
Rates	978.2	1,230.7	1,335.3
Electricity	1,670.6	1,850.3	1,882.9
Water	551.6	486.5	525.9
Other serv. charges	645.7	734.5	798.2
Grants & subsidies	1,564.6	2,161.8	2,448.5
Other income	739.1	443.4	460.1
Total income	**6,149.8**	**6,907.3**	**7,450.9**
Staff costs	(1,616.5)	(1,809.7)	(2,001.4)
Bulk purchases	(1,558.5)	(1,578.2)	(1,604.9)
Depreciation	(807.1)	(779.4)	(830.0)
Net interest	(98.7)	103.0	101.3
Bad debts	(310.9)	(322.7)	(318.0)
Grants & donations	(394.8)	(308.4)	(325.8)
General expenses	(2,921.5)	(1,415.8)	(1,538.6)
Total expenditure	**(5,896.5)**	**(6,111.0)**	**(6,517.4)**
Surplus/(deficit)	**253.3**	**796.2**	**933.5**

Staff costs and bulk purchases remain the main cost drivers as expenditure is expected to rise 4% in FY18 and 7% in FY19. Staff expenses are projected to escalate by 13% in FY18 (exceeding the growth in total income) and 12% higher thereafter. In contrast, bulk purchases are anticipated to remain flat over the next two years despite tariff increases by utility companies. Overall, BCMM expects strong surpluses of R796m in FY18 and R934m in FY19.

Conclusion and rating rationale

BCMM continues to be impacted by the economic challenges particularly impacting the industrial sector. This has constrained economic activity in the region, with the adverse effect on outstanding debt and debt impairments likely to persist. Positively, BCMM continues to receive strong income support from the national government, and remains in a net cash position. In addition, gearing remains modest, allowing for substantial operational freedom. What remains critical for BCMM is the successful implementation of development projects, which can expand its economy.

Buffalo City Metropolitan Municipality

(Rand in millions except as noted)

INCOME STATEMENT Year end: 30 June	2013	2014	2015	2016	2017
Tax revenues	580.1	673.0	794.5	872.4	978.2
General service revenues	427.4	489.7	564.7	625.7	645.7
Trading service revenues	1,536.9	1,709.2	1,860.1	2,133.0	2,222.3
Other income	1,820.5	2,251.8	2,252.8	2,377.2	2,303.7
Total income	**4,364.9**	**5,123.7**	**5,472.1**	**6,008.3**	**6,149.9**
Bad debt write-offs and provisions	(106.8)	(241.0)	(365.1)	(210.1)	(310.9)
Expenses	(3,788.9)	(4,255.3)	(4,683.5)	(5,244.5)	(5,684.2)
Net interest & capital charges	16.7	30.7	63.5	91.4	98.7
Taxation	0.0	0.0	0.0	0.0	(0.6)
Net surplus/(deficit)	**485.9**	**658.1**	**486.9**	**645.0**	**252.8**
BALANCE SHEET					
Funds, reserves & accumulated surplus	**11,032.5**	**13,375.0**	**13,796.8**	**14,951.9**	**17,555.1**
Short term debt	51.7	57.4	48.8	50.7	47.6
Long term debt	600.8	546.0	497.2	445.8	398.1
Total debt	**652.5**	**603.4**	**546.1**	**496.5**	**445.8**
Non-interest bearing liabilities	1,410.1	1,314.2	1,292.8	1,851.2	1,664.1
Total Liabilities	**13,095.1**	**15,292.6**	**15,635.7**	**17,299.6**	**19,664.9**
Fixed Assets & WIP (net of loans redeemed & other capital receipts)	10,087.5	11,828.6	11,987.0	12,974.9	15,826.0
Investments & other (excl. cash investments)	368.6	541.3	558.2	614.9	625.3
Net debtors	596.2	577.4	694.8	1,131.1	1,309.0
Inventory	71.7	50.6	44.9	36.0	38.6
Cash & cash investments*	1,841.7	2,162.7	2,198.8	2,373.9	1,690.1
Other current assets	129.4	132.0	152.1	168.8	175.9
Total Assets	**13,095.1**	**15,292.6**	**15,635.7**	**17,299.6**	**19,664.9**
CASH FLOW STATEMENT					
Cash generated by operations	1,239.7	1,039.3	1,283.3	1,576.1	1,500.5
Utilised to increase working capital	(42.6)	(82.6)	(269.9)	(181.6)	(854.9)
Cash flow from operations	**1,197.1**	**956.8**	**1,013.4**	**1,394.5**	**645.6**
Net capital expenditure	(590.3)	(564.3)	(923.8)	(1,169.8)	(1,276.8)
Net investment activity (excl. cash investments)	(291.1)	(21.1)	3.8	0.0	(1.8)
Borrowings: increase / (decrease)	5.2	(49.1)	(57.3)	(49.6)	(50.7)
Cash and cash investments : (increase)/decrease	(321.0)	(322.2)	(36.1)	(175.1)	683.8
Net debt: increase/(decrease)	**(315.8)**	**(371.3)**	**(93.4)**	**(224.7)**	**633.1**
KEY RATIOS					
Credit Protection Measures:					
Gross interest cover (x)	7.0	9.5	7.0	8.9	3.1
Net interest cover (x)	n.a.	n.a.	n.a.	n.a.	n.a.
Operating cash flow interest cover - gross (x)	17.2	13.7	15.1	20.1	10.1
Operating cash flow : net debt (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Total debt : capital outlays (%)	6.5	5.1	4.6	3.8	2.8
Total debt : total income (%)	14.9	11.8	10.0	8.3	7.2
Net debt*: total income (%)	(16.9)	(26.3)	(26.7)	(27.7)	(16.2)
Net capex : total income (%)	13.5	11.0	16.9	19.5	20.8
Current ratio (:1)	1.8	2.1	2.3	2.0	1.9
Days cash on hand (days)	174.3	182.7	169.2	163.2	107.6
Days cash on hand (days) - excluding unspent conditional grants	131.7	164.6	154.4	148.7	91.6
Bad debt writeoffs : current debtors (%)	10.9	22.6	29.2	12.8	16.8
Efficiency:					
Trading income : total income (%)	35.2	33.4	34.0	35.5	36.1
Staff expenses : total expenses (%)	26.4	26.4	25.9	27.3	27.4
Staff expenses : total incomes (%)	23.5	23.0	23.6	24.4	26.3
Distribution loss - water (%)	45.7	39.5	34.4	40.9	34.1
Distribution loss - electricity (%)	9.5	12.5	15.8	14.5	16.1
Debtors : tax, general & trading income (%)	16.3	12.5	10.1	14.5	16.4
Collection period (days)	59.3	45.8	36.7	52.7	59.7
Gross debtors: total income (%)	22.4	20.8	22.8	27.4	30.1
Net debtors: total income (%)	13.7	11.3	12.7	18.8	21.3
Growth Statistics:					
Increase in tax, gen. & trading income (%)	11.7	12.9	12.1	42.7	68.9
Increase in salaries and allowances (%)	2.7	15.0	9.2	42.8	61.8
Increase in debtors (%)	21.9	9.1	16.9	68.3	130.6
Increase in capex (%)	178.9	(4.4)	63.7	26.6	9.2
Increase in net debt (%)	n.a.	n.a.	n.a.	n.a.	n.a.

*Includes all unspent grants and subsidies.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S CORPORATE SECTOR GLOSSARY

Bad Debt	A bad debt is an amount owed by a debtor that is unlikely to be paid due, for example, to a company going into liquidation. There are various technical definitions of what constitutes a bad debt, depending on accounting conventions, regulatory treatment, and the individual entity's own provisioning and write-off policies.
Balance Sheet	Also known as Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capital	The sum of money that is invested to generate proceeds.
Capital Expenditure	Expenditure on long-term assets such as plant, equipment or land, which will form the productive assets of a company.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Current Ratio	A measure of a company's ability to meet its short-term liabilities and is calculated by dividing current assets by current liabilities. Current assets are made up of cash and cash equivalents ('near cash'), accounts receivable and inventory, while current liabilities are the sum of short-term loans and accounts payable.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Economic Indicators	Statistical data about country's economy, such as unemployment figures, the Consumer Price Index (CPI), Gross Domestic Product (GDP), money supply and housing statistics. This data gives information about the future direction of output and demand in an economy.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Fixed Assets	Assets of a company that will be used or held for longer than a year. They include tangible assets, such as land and equipment, stake in subsidiaries and other investments, as well as intangible assets such as goodwill, information technology or a company's logo and brand.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA.
Impairment	Reduction in the value of an asset because the asset is no longer expected to generate the same benefits, as determined by the company through periodic assessments.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long-Term Rating	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Mandate	Authorisation or instruction to proceed with an undertaking or to take a course of action. A borrower, for example, might instruct the lead manager of a bond issue to proceed on the terms agreed.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Operating Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
Performing Loan	A loan is said to be performing if the borrower is paying the interest on it on a timely basis.
Pledge	An asset or right delivered as security for the payment of a debt or fulfillment of a promise, and subject to forfeiture on failure to pay or fulfill the promise.
Receivables	Any outstanding debts, current or not, due to be paid to a company in cash.
Revaluation	Formal upward or downward adjustment to assets such as property or plant and equipment.
Short-Term Rating	A short term rating is an opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Term Deposit	A savings account held for a fixed term. Also called a time deposit. Generally, there are penalties for early withdrawal.
Working Capital	Working capital usually refers to the resources that a company uses to finance day-to-day operations. Changes in working capital are assessed to explain movements in debt and cash balances.

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SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the ratings process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; c.) such ratings are an independent evaluation of the risks and merits of the rated entity, security or financial instrument; and d.) the validity of the rating is for a maximum of 12 months, or earlier as indicated by the applicable credit rating document.

Buffalo City Metropolitan Municipality participated in the rating process via face-to-face management meetings, teleconferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit ratings has been disclosed to Buffalo City Metropolitan Municipality with no contestation of the ratings.

The information received from Buffalo City Metropolitan Municipality and other reliable third parties to accord the credit rating(s) included;

- Audited financial statements for the year ended 30 June 2017 (Plus four years of comparative audited numbers):
- Budget reports up to 2020;
- The Integrated Development Plan for 2017/2018;
- Most recent schedule C schedule accounts;
- Most recent statement of comparison of budget and actual information; and
- Industry comparative data.

The ratings above were solicited by, or on behalf of, the rated client, and therefore, GCR has been compensated for the provision of the ratings.